The American Recovery and Reinvestment Act of 2009 and Colorado Government

by Rene M. Adema, Michael R. Johnson, and Frederic H. Marienthal

ARRA will increase demand in the capital markets for debt issued by Colorado governments. Colorado law has been changed to permit state and local governments to fully use the finance tools created by ARRA.

President Barack Obama signed the American Recovery and Reinvestment Act of 2009 (ARRA)¹ into law in Denver on February 17, 2009. ARRA is the most significant tax legislation affecting state and local government finance since the Tax Reform Act of 1986.

One of ARRA's intended benefits is to increase demand in the capital markets for debt issued by state and local governments. ARRA accomplishes this by creating five new financial products, increasing volume cap for three existing financial products, and modifying the effect of the alternative minimum tax on certain tax-exempt municipal bonds. Many of the details and technical provisions of ARRA are still being interpreted and formulated by the U.S. Treasury Department (Treasury), and there will be additional guidance promulgated by the Treasury from time to time.

Overview of Municipal Finance

Section 103(a) of the Internal Revenue Code of 1986, as amended (Code), allows state and local governments to issue tax-exempt municipal bonds on an advantageous basis by excluding from gross income for federal income tax purposes interest on any "state or local bonds," which are defined as any obligation of any state or political subdivision thereof. The tax-exempt municipal bond market is a multi-trillion dollar industry. *The Bond Buyer* reports that in 2008 alone, state and local governments issued \$2.69 trillion of tax-exempt municipal bonds.² Tax-exempt municipal finance is particularly advantageous to state and local governments because of the reduced borrowing costs associated with tax-exempt debt. Interest

rates on tax-exempt municipal debt typically will price approximately 30 percent lower than the interest rates on taxable debt.

As background, in 1895, the U.S. Supreme Court first considered the constitutionality of the federal government imposing a tax on the interest paid to bondholders on state and local governmental tax-exempt obligations. The Court held:

As the states cannot tax the powers, the operations, or the property of the United States, nor the means which they employ to carry their powers to execution, so it has been held that the United States have no power under the Constitution to tax either the instrumentalities or the property of a state.³ ... [T]axation of interest [from municipal securities] would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of the states and their instrumentalities to borrow money, and consequently repugnant to the Constitution.

The Court's holding remained largely uncontested through 1913, until the passage of the Sixteenth Amendment. In response, Congress codified the exemption of interest on state and local governmental obligations from federal income taxation in the Revenue Act of 1913.

Historically, the Code permitted the issuance of tax-exempt municipal bonds for both private and governmental projects. Congress, in response to the proliferation of the issuance of tax-exempt municipal debt and the resulting perceived loss of federal tax revenue, prohibited the issuance of tax-exempt municipal bonds for any private purpose except in very limited circumstances. The result

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was that Congress created two classes of municipal bonds; governmental bonds, which are tax-exempt bonds used to finance projects generally owned and operated by state and local governmental entities; and qualified private activity bonds, which are tax-exempt bonds used to finance projects generally owned and operated by 501(c)(3) entities or certain private entities operating certain businesses expressly enumerated in the Code.

New Financial Products

ARRA creates five new financial products, including two categories of Build America Bonds, Recovery Zone Economic Development Bonds, Recovery Zone Facility Bonds, Qualified School Construction Bonds, and Tribal Economic Development Bonds. Each of these new financial products is described below.

Build America Bonds

ARRA created a new class of tax-credit bonds called Build America Bonds. Build America Bonds can be used to finance any governmental project that otherwise could be financed with proceeds of tax-exempt municipal bonds under Code § 103. The interest paid on a Build America Bond is taxable to the holder.

ARRA creates two classes of Build America Bonds. The first is the Refundable-Credit Build America Bond, which provides the issuer with a refundable credit in the amount of 35 percent of the interest payable by the issuer on each interest payment date. This refundable credit is paid by the Treasury directly to the issuer. The second is the Holder-Credit Build America Bond, which provides the holder with a federal tax credit equal to 35 percent of the interest paid to the holder on each interest payment date. Build America Bonds must be issued before January 1, 2011 and cannot be issued with more than a *de minimus* amount of premium.

Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds

ARRA created Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds that can be issued to finance

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projects located within a recovery zone. A recovery zone includes the following:

- 1) any area designated by the issuer as having significant poverty, unemployment, rate of home foreclosures, or general distress;
- 2) any area designated by the issuer as economically distressed by reason of the closure or realignment of military installation pursuant to the Defense Base Closure and Realignment Act of 1990; and
- 3) any area for which a designation as an empowerment zone or renewal community is in effect.

The Recovery Zone Economic Development Bond is a tax-credit bond and is similar to a Build America Bond in that there is a Holder-Credit Recovery Zone Economic Development Bond and a Refundable-Credit Recovery Zone Economic Development Bond. The Holder-Credit Recovery Zone Economic Development Bond provides the holder with a federal tax credit equal to 35 percent of the interest paid to the holder on each interest payment date. The Refundable-Credit Recovery Zone Economic Development Bond provides the issuer with a 45 percent refundable credit.

The Recovery Zone Economic Development Bonds can be issued to finance any qualified economic purpose, which includes:

- 1) development or other economic activity in a recovery zone, including capital expenditures incurred with respect to property located within a recovery zone;
- 2) public infrastructure and construction of public facilities; and
- 3) job training expenditures.

The authorized national cap for Recovery Zone Economic Development Bonds is \$10 billion, which will be allocated by the Internal Revenue Service (IRS) to the states based on each state's proportionate employment decline in 2008. All Recovery Zone Economic Development Bonds must be issued prior to January 1, 2011.

The Recovery Zone Facility Bond is a traditional tax-exempt bond, meaning the interest paid to the holder of the bond is exempt from federal income tax. These bonds can be issued to finance recovery zone property, which includes: property constructed, reconstructed, renovated, or acquired by a taxpayer within a recovery zone; the original use of which commences with the taxpayer; and that is used in the active conduct of a qualified business of the taxpayer in such zone, excluding residential rental property and a few other business such as gambling facilities, country clubs, and liquor stores.

The authorized national cap for Recovery Zone Facility Bonds is \$15 billion, which will be allocated by the IRS to the states based on each state's proportionate employment decline in 2008. All Recovery Zone Facility Bonds must be issued before January 1, 2011.

Qualified School Construction Bonds

ARRA also creates Qualified School Construction Bonds that can be issued to finance the construction, rehabilitation, or repair of public school facilities or the acquisition of land on which such schools will be located. This includes, among other things, expenditures for the costs of acquisition of equipment to be used in such schools. For each of calendar years 2009 and 2010, \$11 billion of Qualified School Construction Bond cap has been authorized for states and large school districts, which will be allocated by the IRS.

There is a separate cap of \$200 million authorized for allocation to Indian tribal governments, which will be allocated by the Secre-

tary of Interior. Such amounts may be used to finance the construction, rehabilitation, and repair of schools funded by the Bureau of Indian Affairs.

Tribal Economic Development Bonds

ARRA also creates a new class of Tribal Economic Development Bonds. These are traditional tax-exempt bonds that can be issued by Indian tribal governments to finance nonessential governmental functions that would qualify for tax-exemption under Code § 103 if issued by a state or local government. Prior to this change, the Code permitted Indian tribal governments to issue bonds solely for essential governmental functions. ARRA prohibits the financing of any buildings housing class II or class III gaming, any property used in the conduct of class II or class III gaming, and any facilities located outside an Indian reservation. ARRA allows for an allocation of up to \$2 billion in each of 2009 and 2010. The IRS will pronounce either a project-based or formula-based allocation method.

Allocation Increases for Certain **Existing Financial Products**

In addition to creating several new financial products to be used by state and local governments, ARRA increases the allocation issuance authority for several existing tax-credit bonds, including Clean Renewable Energy Bonds, Qualified Energy Conservation Bonds, and Qualified Zone Academy Bonds.

Clean Renewable Energy Bonds can be issued to finance facilities that generate electricity from various sources, such as wind, closed-loop biomass, open-loop biomass, solar energy, geothermal, hydropower, and trash combustion facilities. This allocation was increased from \$800 million to \$2.4 billion.

Qualified Energy Conservation Bonds can be issued to finance state, municipal, and tribal government programs designed to reduce greenhouse gas emissions that meet certain statutory requirements for qualified conservation purposes. This allocation was increased from \$800 million to \$3.2 billion.

Qualified Zone Academy Bonds can be used to finance school renovations, equipment purchases, course materials, and the training of teachers at certain public school facilities below the college level that are located in empowerment zones or enterprise communities. This allocation was increased by \$2.4 billion for each of 2009 and 2010. The previous allocation was \$400 million through 2009.

Changes Affecting Holders of Tax-Exempt Municipal Bonds

ARRA implements several changes to existing laws that are designed to increase market demand for tax-exempt municipal bonds. Specifically, these changes include modifying existing bank qualification provisions under § 265 of the Code, as well as exempting certain interest paid on tax-exempt municipal bonds from the alternative minimum tax.

Prior to ARRA, Code § 265 allowed an issuer to designate taxexempt municipal bonds as "bank qualified bonds," provided that,

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among other things, the issuer did not intend to issue more than \$10 million in tax-exempt bonds in that calendar year. Tax-exempt municipal bonds designated as "bank qualified" generally price at yields below non-bank-qualified tax-exempt municipal bonds. ARRA has increased this threshold from \$10 million to \$30 million. Additionally, ARRA now allows any 501(c) organization, as a conduit borrower, to be treated as a separate issuer for purposes of applying this \$30 million threshold test.

The interest paid on most private activity tax-exempt municipal bonds generally has been subject to the alternative minimum tax (AMT) and has been includable in a corporation's adjusted current earnings (ACE) for AMT purposes, which ultimately has caused such bonds to price higher than non-AMT bonds. ARRA provides that interest paid on private activity bonds issued in 2009 and 2010 to either finance new capital projects or refinance certain tax-exempt municipal bonds issued during 2004 through 2008 will not be subject to AMT and will not be includable in a corporation's ACE.

Colorado State Law

House Bill (H.B.) 09-1346,⁵ the Colorado Recovery and Reinvestment Finance Act of 2009, was enacted by the Colorado General Assembly to authorize Colorado governments to fully use the new finance tools created by ARRA. This new legislation is designed to implement ARRA's provisions and allow the state and its cities, schools, higher educational institutions, and other political subdivisions to more easily and cheaply issue bonds (stimulus

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bonds) to build and repair infrastructure. The changes effected by H.B. 09-1346 that permit the issuance of the new stimulus bonds are discussed below.

Who May Issue

Any Colorado government may issue stimulus bonds. H.B. 09-1346 also authorizes two or more Colorado governments to create a Recovery and Reinvestment Finance Act Authority to issue stimulus bonds on a pooled basis.

Bonds or Lease Purchase Agreements

Stimulus bonds may be issued as bonds or as certificates of participation evidencing interests in payments under a lease purchase agreement. Therefore, stimulus bonds may be issued by Colorado governments as either long-term multiple fiscal year indebtedness or certificates of participation subject to annual appropriation.

Bond Terms

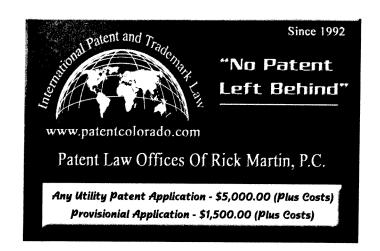
Stimulus bonds may be issued with any original issue discount or premium or any redemption provisions, at any fixed or variable interest rate, in any denominations, and with maturities up to forty years. Principal, interest, and federal direct payments may be stripped from one another and may be issued and transferred as separate securities.

Investments

Investments of deposits into sinking funds for stimulus bonds that are issued with deferred maturities (which are common for tax credit bonds) are specifically authorized. Permitted investments also are expanded.

State Credit Enhancement Programs

Existing state credit enhancement programs may be used with stimulus bonds. These programs include: (1) the school district intercept program; (2) the charter school intercept and moral obligation programs; (3) the higher education state intercept program; and (4) the new school district certificate of participation moral obligation program included in the 2009 school finance act.⁶



Federal Direct Payments

Colorado governments that issue Build America Bonds or Recovery Zone Economic Development Bonds may elect to receive a direct payment from the federal government instead of a tax credit to the bondholder, and may use the federal direct payment to pay debt service on the bonds or for any legal purpose. Federal direct payments that are used to pay debt service are netted against and reduce interest under Colorado law, including interest and repayment limits under ballot questions, Colorado statutes, and the Colorado Constitution. Except for Build America Bonds, for which there is no volume cap, the dollar amount of all other stimulus bonds is subject to annual volume caps. These are discussed below.

School construction bonds. State volume cap for 2009 is \$87,147,000.7 Denver Public Schools' direct volume cap (as a result of number of students in poverty) for 2009 is \$24,022,000.8 The state allocation will be used for the Build Excellent Schools Today (B.E.S.T.) program but may be reallocated to other school districts and charter schools by the B.E.S.T. board.

Energy conservation bonds. State volume cap for 2009 is \$51,244,000.9 The Governor's Energy Office will allocate the volume cap among large counties and municipalities (population greater than 100,000) based on the ratio of population to the total state population. The remainder will be allocated to the state for use by the state or reallocation to large counties and municipalities.¹⁰

Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds. The state volume cap for these bonds has not yet been announced by the Treasury. The estimated amount of volume cap for 2009 for Colorado for Recovery Zone Economic Development Bonds is \$73.14 million and for Recovery Zone Facility Bonds is \$109.70 million.11 The Commission on Higher Education will allocate the volume cap for both types of bonds to counties and large municipalities (population greater than 100,000), based on the ratio of the 2008 employment decline, to the total state 2008 employment decline for the purpose of financing or refinancing projects that are owned or used by institutions of higher education and approved by the Commission on Higher Education. 12 Any volume cap not used by September 1, 2010 will be allocated by the Department of Local Affairs to counties and large municipalities for any purpose permitted under federal law (the higher education restriction lapses).¹³

Qualified Zone Academy Bonds. State volume cap for 2009 is \$19,930,000.¹⁴ The state B.E.S.T. board will allocate the volume cap to school districts for district and charter school improvement projects that qualify based on private sector participation.¹⁵

Clean Renewable Energy Bonds and New Clean Renewable Energy Bonds. The volume caps are national and are administered by the Treasury pursuant to an application process.

Expiration of volume cap allocations. Governments to which a volume cap is allocated under H.B. 09-1346 must issue bonds or execute a bond purchase agreement by November 11 of a calendar year. Any volume cap not used to issue bonds by November 30 of a

calendar year reverts to the statewide balance for reallocation or carry forward to the next year. ¹⁶

Issuers of stimulus bonds must report on bonds issued within thirty days of issuance.¹⁷ Failure to file the report does not adversely affect the validity of the bonds, but the issuer cannot issue additional stimulus bonds until reports for all earlier issues have been filed.¹⁸

Conclusion

ARRA's newly created financial products will provide Colorado governments access to cheaper funds to finance and repair infrastructure, buildings, and schools, as well as for energy projects and workforce development, among other projects. The expenditures of these funds will stimulate the Colorado economy and create new jobs. Although financing for many of these projects has always been available to governmental entities through the issuance of traditional tax-exempt bonds, given the existing credit markets, the creation of various new tax-credit products to finance these same projects is designed to expand the markets that will purchase governmental debt.

Notes

- 1. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009). *See also* recovery.gov home page, www.recovery.gov.
- Seymour, "Retail Props Up Muni Market in 4Q," The Bond Buyer 1 (March 18, 2009).
 - 3. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 584 (1895).
- 4. Defense Base Closure and Realignment Act of 1990, 10 U.S.C. § 2687.
- 5. H.B. 09-1346, 67th Gen. Assem., Reg. Sess. (Colo. 2009), available at www.leg.state.co.us/clics/clics/2009a/csl.nsf/billcontainers/E18BB82 D956F0EC4872575890076EB29/\$FILE/1346_enr.pdf.
 - 6. S.B. 09-256, 67th Gen. Assem., Reg. Sess. (Colo. 2009).
 - 7. I.R.S. Notice 2009-35, 2009-17 I.R.B. 876.
 - 8. *Id*.
 - 9. I.R.S. Notice 2009-29, 2009-16 I.R.B. 849.
- 10. H.B. 09-1346, *supra* note 5, to be codified at CRS § 11-59.7-107(1).
- 11. Bovee, "Analysis of TE REZ Bond Allocation By State" (April 3, 2009), available at www.cdfa.net/cdfa/cdfaweb.nsf/fbaad5956b2928b086 256efa005c5f78/bab2f496cb65154d8625759300662830/\$FILE/Analysis%20of%20TE%20REZ%20Bond%20Allocation%20By%20State.pdf. This analysis is based on projections and data prepared, extracted, and analyzed by David Bovee, Zenith Assets, Inc., as of April 3, 2009. The U.S. Department of the Treasury has not as of the date of publication of this article released official data.
- 12. H.B. 09-1346, *supra* note 5, to be codified at CRS § 11-59.7-108(1) and (2).
 - 13. Id., to be codified at CRS § 11-59.7-108(5).
 - 14. I.R.S. Notice 2009-30, 2009-16 I.R.B. 852.
- 15. H.B. 09-1346, *supra* note 5, to be codified at CRS § 11-59.7-109(1).
 - 16. See, e.g., id., to be codified at CRS § 11-59.7-106(2).
 - 17. Id., to be codified at CRS § 11-59.7-111(1).
 - 18. *Id.*, to be codified at CRS § 11-59.7-111(2). ■

